

# Fitch Lwrs California GOs & Leases to 'BBB', Negative Watch Continues

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Fitch Ratings-New York-December 18, 2003: Fitch Ratings has lowered the state of California's general obligation bond rating to 'BBB' from 'A', with the exception of the self-supporting veterans bonds (\$1.9 billion outstanding) whose rating remains 'A'. The rating action affects \$29.9 billion general obligation bonds.

In addition, the ratings assigned to several lease obligations have been lowered to 'BBB' from 'A-'. They were issued by the Public Works Board, the Franchise Tax Board, East Bay State Building Authority, Los Angeles State Building Authority, Oakland State Building Authority, Riverside County Public Financing Authority, Sacramento City Financing Authority, San Bernardino Joint Powers Financing Authority and San Francisco State Building Authority. All of the ratings remain on Rating Watch Negative to indicate the potential for further financial deterioration.

California's widening budget gap, its intention to increase the amount to be raised from deficit funding and the magnitude of measures necessary to restore balance, which may become mandated, underlie the rating downgrade. Financial plans rely heavily on the completion of a deficit financing as \$14 billion short-term notes are due in June. The decision to submit the bonds and the balanced budget proposal to the electorate injects another element of uncertainty.

California's continuing financial problems are rooted in the unprecedented decline in personal income tax collections since fiscal 2001, further complicated by the effects of the recession and delayed recovery. A budget gap for fiscal years 2002 and 2003 was identified at \$38 billion, addressed by a planned deficit financing of \$10.7 billion, other borrowings of almost \$7 billion and expenditure cuts and savings. Many of the measures were non-recurring, leaving a gap estimated at about \$8 billion to be confronted in the fiscal 2005 budget.

Following the recall election, the new administration repealed the vehicle license tax, at an ongoing cost of over \$4 billion annually and this, together with other budgetary developments, has increased that gap to around \$14 billion, and may cause a deficit this year. The planned deficit funding of \$10.7 billion has been enlarged to \$15 billion.

The deficit bonds, general obligation and supported by a sales tax, and a companion budget balancing measure will be on the March 2004 ballot and both must pass for either to be effective. There is risk involved and should passage not occur, the back-up plan is use of stand-alone sales tax bonds; those bonds are for a lesser amount, are not yet validated and might appear in contradiction of the electorate's intent. If the measures prevail, there is also risk, as passage of a balanced budget is mandated. The estimated gap for fiscal 2005 is equal to 17% of projected current law expenditures. Should spending cuts be relied on, it is impossible to predict if reductions of such magnitude can be made, or, if made, what effect they might have on services. The executive budget with its recommendations for balance is due Jan. 10.

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